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No. 87-303

Supreme Court, U.S.
FILED
SEP. 23 1987
JOSEPH F. SPANIOL, JR.
CLERK

In The
Supreme Court of the United States
October Term, 1987

DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DE BENEDETTI, EMMETT R. DeMOSS, JR., SIMONE FUBINI, B. J. MEREDITH and ELSERINO M. PIOL,

Petitioners,

v.

HANNAH FINKEL,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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29 pp

QUESTION PRESENTED

Is a plaintiff class of investors which purchases securities in an established market at a price artificially inflated by a scheme to defraud or course of business that operates as a fraud on investors, entitled to a presumption of reliance in order to recover for securities fraud under Section 10(b) of the 1934 Act and Rule 10b-5(1) and (3) thereunder?

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No. 87-303

In The
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DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DE BENEDETTI, EMMETT R. DeMOSS, JR., SIMONE FUBINI, B. J. MEREDITH and ELSERINO M. PIOL,

Petitioners,

v.

HANNAH FINKEL,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Respondent Hannah Finkel respectfully requests that the Court deny the Petition for Certiorari to the United States Court of Appeals for the Fifth Circuit ("Petition") submitted by Docutel/Olivetti Corporation ("Docutel") and several individuals (collectively the "Defendants") to review a final judgment of the United States Court of

Appeals for the Fifth Circuit. The judgment appealed from (i) reversed the District Court's Order granting Defendants/Petitioners' Motion to Dismiss dismissing Plaintiff's claims under 10b-5(1) and (3) of the Securities and Exchange Commission, and (ii) affirmed the District Court's Order granting Defendants' Motion to Dismiss Plaintiff's claims under Rule 10b-5(2) of the Securities and Exchange Commission.

STATEMENT OF THE CASE

Course of Proceedings and Disposition Below

Plaintiff's complaint arises under Sections 10(b) and 20 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78(a), *et seq.* (the "Exchange Act") and Securities and Exchange Rule 10b-5 promulgated thereunder. Plaintiff brought this action as a class action pursuant to Rules 23 (a) and (b)(3) F.R.C.P.

Defendants filed a Motion to Dismiss. The Motion to Dismiss alleged that the Complaint is fatally defective for failure to allege individual reliance upon misrepresentations of Defendants.

Discovery and class certification were deferred pursuant to agreed orders pending a ruling by the District Court on Defendants' Motion to Dismiss.

On August 20, 1986, the District Court dismissed the Plaintiff's Complaint without prejudice based upon an interpretation of *Shores vs. Sklar,* 647 F.2d 462 (5th Cir. 1981) (en banc), *cert. denied,* 459 U.S. 1102 (1983), to the

effect that a plaintiff in the Fifth Circuit who purchases securities in an established market cannot rely upon the integrity of the market pursuant to the fraud on the market doctrine, but must plead and prove individual reliance upon specific misrepresentations.

On May 27, 1986, the Fifth Circuit reversed and remanded, holding that to the extent that Plaintiff's Complaint alleged a scheme to defraud or course of business operating as a fraud, Plaintiff had properly pled causes of action under 10b-5(1) and (3). Plaintiff did not have to plead specific reliance upon alleged misrepresentations. The Fifth Circuit affirmed the District Court's dismissal of Plaintiff's Complaint with respect to claims under 10b-5(2), holding that under *Shores,* any fraud on the market claim under section (2) is barred by Plaintiff's failure to allege that she read and relied on any of the documents now claimed to have misrepresented the financial condition of Docutel.

On August 29, 1987, the District Court stayed this action pending this Court's ruling on Petitioner's petition for a writ of certiorari.

STATEMENT OF FACTS

Defendant Docutel/Olivetti Corporation ("Docutel") is a Delaware corporation with executive offices in Irving, Texas. On October 1, 1983, Docutel had issued and outstanding 6,800,000 shares of common stock owned by more than 3,200 shareholders. Docutel's shares were traded in

the over-the-counter market. Defendant Ing. C. Olivetti and C., S.p.A. ("Olivetti") is an Italian corporation with its executive offices located in Italy. Olivetti acquired practical control of Docutel by means of a merger between a subsidiary of Olivetti and Docutel, and the issuance of a warrant by Docutel to the Olivetti subsidiary. Defendants B. J. Meredith and Emmett R. DeMoss were, respectively, the chief executive officer and executive vice president and chief financial officer of Docutel.

Defendants Carlo DeBenedetti and Simone Fubini were respectively the chief executive officer and chief operating officer of Olivetti. Defendant Elserino M. Piol was a reprcsentative of Olivetti who acted as a director of Docutel.

On December 5, 1983, Plaintiff purchased 300 shares of Docutel on the public market at $14-5/8 per share, for a total price of $4,474.75.

Plaintiff alleged that the quarterly earnings of Docutel reported through 1983 were substantially overstated, and losses were understated, by reason of the failure of Docutel, and Olivetti as its controlling shareholder, and the respective officers, to charge off worthless inventories acquired from Olivetti and its subsidiary. Docutel was made to buy inventory from Olivetti which was unsalable, giving rise to the write-downs complained of by Plaintiff in this action.

Plaintiff relied upon the integrity of the public market for Docutel shares in making her purchases and thereby incurred losses by paying the artificially inflated public market prices resulting from the fraudulently overstated earnings.

On February 16, 1984, Docutel announced a projected net loss for the year ended December 31, 1983, in the amount of $14,000,000. On April 2, 1984, the *Wall Street Journal* reported that Docutel said its previously projected net loss for 1983 of $14,000,000 would be significantly wider. In its 10-K for 1983 Docutel reported an after tax loss of $18,263,000 for 1983. The loss included $10,900,000 of inventory write-downs, approximately $10,100,000 of which was recorded in the fourth quarter. Significantly, Docutel made the following admission in its 1983 Form 10-K:

> In 1983, the Company's record keeping procedures and accounting staff were strained due to the significant growth in transaction volume resulting from the merger with Olivetti Corporation, attrition of personnel, and the transfer in the second half of 1983 of OPD accounting function from Tarrytown, New York, to the Company's headquarters in Irving, Texas.

Docutel's stock plummeted from a high of $38-7/8 in 1983 to a closing bid price on April 6, 1984 of $7-1/4, causing public investors to take large losses.

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REASONS FOR DENYING THE PETITION

I. RESPONDENTS WERE ENTITLED TO A REBUTTABLE PRESUMPTION OF RELIANCE UNDER THE FRAUD ON THE MARKET THEORY

The Fifth Circuit Court of Appeals in this case correctly held that since Respondent had alleged a scheme to defraud or course of business operating as a fraud in viola-

tion of Rule 10b-5(1) and (3), Respondent was entitled to a rebuttable presumption of reliance upon proof of materiality of the alleged conduct.

Reliance is generally a requirement to a claim stated under Rule 10b-5. Proof of reliance establishes that the damaged party was induced to act by the defendant's conduct; it defines the causal link between defendant's misconduct and the plaintiff's decision to buy or sell securities. *Dupuy v. Dupuy*, 551 F.2d 1005, at 1016 (5th Cir. 1977), *cert. denied*, 434 U.S. 911 (1977); *Finkel v. Docutel/Olivetti*, 817 F.2d 356 at 359 (5th Cir. 1987). The fraud on the market doctrine, adopted by every Circuit Court of Appeals to consider it[1] permits a plaintiff to rely upon the integrity of an established market to set a price untainted by fraud, without pleading individual reliance upon specific misrepresentations. Most courts have held that a plaintiff is entitled only to a presumption of reliance, which may be rebutted by defendants. In this case, the Court of Appeals held that Defendants may rebut the presumption of reliance in two ways: 1) by showing that the nondisclosures did not affect the market price for the

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[1]See *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986); *Levinson v. Basic*, 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 107 S. Ct. 1284 (Feb. 23, 1987); *Harris v. Union Electric Co.*, 787 F.2d 355 (8th Cir. 1986), *cert. denied*, No. 85-2036 (Oct. 6, 1986); *Lipton v. Documentation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983); *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot after cert. granted*, 459 U.S. 1027 (1982); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

security; or 2) that plaintiff would have purchased the stock at the same price even if she had known the information that was not disclosed. *Docutel*, 817 F.2d at 364-365.

The fraud on the market doctrine is premised upon the theory that the market price for a security, in an open and developed market, accurately reflects the value of that security if all relevant information has been disclosed in the marketplace.[2] When one fails to disclose or misrepresents material information about a security, the market's efficient pricing mechanism is skewed and the price of the security is distorted. *Docutel*, 817 F.2d at 360. The fraud on the market doctrine recognizes the fact that most investors do not carefully examine all available information about a security because there is too much, and much of it is too technical.[3] Instead the typical investor relies upon the in-

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[2]This is a conclusion of the efficient market theory. The theory states that the market price reflects all representations concerning the stock. The market price of securities is a function of the information the market possesses, both positive and negative, assuming all information is disclosed. *In re LTV Securities Litigation*, 88 F.R.D. 134, 144 (N.D.Texas 1980). *See LTV* for citations to the economic theories and leading works which support the doctrine. *See also*, Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus.L 1 (1982); Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J.Fin. 383 (1970); Note, *Fraud-on-the-Market Theory*, 95 Harv.L.Rev. 1143 (1982); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 Stan. L. Rev. 1031 (1977).

[3]*See*, Fischel, 38 Bus. Law, 1, 2-5; *Docutel*, 817 F.2d at 360 n. 9 ("[R]ecent scholarship suggests that the dissenters' vision of individual investors reading and relying upon information required to be disclosed in registration statements and the like is suspect. Most SEC disclosure documents not only go unread by their intended recipients but in fact 'can only be used effectively by market professionals.' ") (quoting Note, *The Fraud-on-the-Market Theory*, 95 Harv.L.Rev. 1143, 1159 (1982) and H. Kripke, *The SEC and Corporate Disclosure* at 14 (1979)).

tegrity of the market to be free from deception and to value accurately a security in light of all the material information about the security. The market becomes the theoretical agent of the investor. Consequently, a purchaser or seller who relies on the market to value the security accurately suffers damages if the market does not have all the information or if some of the information is false.

The ability of an investor to rely upon the market price for securities as reflecting an individual issuer's prospects is critical to liquidity in the nation's capital markets. Most investors rely upon the integrity of the public market when they invest. The typical investor has insufficient time to review all of the data available with respect to individual securities considered for purchase. Thus, there are important economic bases, as well as legal bases, for the fraud on the market doctrine. It is for these reasons that the fraud on the market doctrine has been adopted in every circuit to consider it. *See* note 1 above.

II. THE FRAUD ON THE MARKET DOCTRINE FURTHERS THE CLEAR INTENT OF CONGRESS.

Petitioners wrongly contend that in adopting Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), Congress intended to incorporate the basic elements of common law fraud. Petitioners mischaracterize Congress' intent in an attempt to overturn the fraud on the market doctrine against the great weight of judicial, scholastic and administrative authority that supports it.[4] The

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[4]See *supra* note 1 and accompanying text; *Docutel*, 817 F.2d at 361 ("The Securities and Exchange Commission accepts the efficient market hypothesis, which underlies the fraud on the

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creation of the many new rules contained in the '33 and '34 Acts constitutes Congressional recognition of the inability of state common law principles to deal with securities fraud. Nowhere in the text of Section 10(b), or Rule 10b-5 promulgated thereunder, are the alleged elements of common law fraud required.[5] Section 10(b) was deliberately couched in broad terms and intended to be a catch-all to prevent manipulative devices that theretofore ran rampant.[6]

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market theory.") (footnote omitted); *see also* Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L.Rev. 435 (1984); Rapp, *Rule 10b-5 and "Fraud-on-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 Wash.& Lee L.Rev. 861 (1982); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 Geo. Wash. L. Rev. 627 (1982); Note, *Fraud-on-the-Market Theory*, 95 Harv. L. Rev. 1143 (1982).

[5]At the outset, Petitioners cite *Kardon v. National Gypsum*, 69 F.Supp. 512 (E.D.Penn. 1946) for the proposition that the cause of action under Rule 10b-5 has always incorporated the basic elements of the common law deceit action. This is simply not correct. In *National Gypsum* the plaintiffs made claims based upon both common law fraud and Rule 10b-5. The court held that plaintiff's allegations sustained both claims. Nowhere did the court require the allegations of a common law fraud claim as a prerequisite to a claim under Rule 10b-5. The court simply held that the allegations as they were made sufficed to uphold claims under both 10b-5 and common law fraud.

[6]In summing up Section 9(c) before the House Committee, which without significant alteration became Section 10(b) of the Act, one of the principal drafters said the following:

> "Subsection (c) says, 'Thou shalt not devise any other cunning devices.' . . . Of course subsection . . . (c) is a catch-all clause to prevent manipulative devices[.] I do not think there is any objection to that kind of a clause. The Commission should have authority to deal with new manipulative devices."

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The fraud on the market theory actually embraces Congress' intent. The fraud on the market theory adheres to legislative intent by fostering public confidence in the markets, by deterring fraud and by promoting judical efficiency through the class action vehicle.

Restoring investor confidence in the securities markets was a primary reason for adopting the federal securities laws. *See* 1 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud*, Section 2.2(110) at 2:13 (1986) ("[Statutory antifraud provisions] were part of the initial New Deal response to the financial debacle of the 1920's, investigations of which revealed widespread fraud, manipulation and victimization of public investors by concealment of relevant information"). With respect to Section 10 and Rule 10b-5, courts have held that "[t]he statute and rule are designed to foster an expectation that securities markets are free from fraud—an expectation on which purchasers should be able to rely." *Blackie v. Barrack*, 524 F.2d at 907; *see also, Lipton v. Documation*, 734 F.2d at 748. The ability of an investor to rely upon the honesty and integrity of the market is critical to liquidity in the nation's capital markets. As one court has noted, "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would know-

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Testimony of Thomas G. Corcoran, Hearing on HR 7852 and HR 8720 before the House Committee on Interstate and Foreign Commerce, 73d Congress, 2d Sess., 115 (1934). The courts have quoted this comment in giving broad interpretation to Section 10(b). *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 766 (1975) (dissent of Blackmun J.); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 859 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969).

ingly roll the dice in a crooked crap game?'' *Schlanger v. Four-Phase Systems, Inc.*, 555 F.Supp. 535, 538 (S.D. N.Y. 1982).

The fraud on the market doctrine recognizes the fact that the legislative policy designed to foster investor expectations of honesty in the securities markets has become reality. Investors rely upon the integrity of the market when they invest. They purchase upon the assumption that the market price is free from any unsuspected manipulation that could inflate the market price. The fraud on the market doctrine simply furthers the goals of the securities laws by protecting those that rely on the integrity of the market when they invest. *Blackie v. Barrack*, 524 F.2d at 907. Such investors may recover from corporate wrongdoers without proving individual reliance on specific misrepresentations, but by showing that they relied upon the integrity of the market when they purchased the security —an expectation on which purchasers should be able to rely. Requiring direct proof from each purchaser that he relied on a particular representation when purchasing would defeat recovery by those whose reliance was indirect or on the integrity of the public market place. The securities laws would operate to protect only those investors with enough time and sophistication to digest all information disseminated into the public market, despite the fact that all investors who rely on the honesty of the market suffer the damage of purchasing a security at a price inflated by material misrepresentations. To leave such open market purchasers unprotected is not consistent with the policies under the federal securities laws. Investors should and do rely upon the integrity of the public market when they invest.

To the extent that private securities fraud actions may be prosecuted more efficiently by adoption of the fraud on the market theory, the enforcement of the securities laws, and the underlying goal of honest markets, are furthered. Brief for the Securities and Exchange Commission as Amicus Curiae at 26, *Basic v. Levinson,* No. 86-279 (U.S. filed April 1987). There is no doubt that implied private actions under 10b-5 effectively enforce the securities laws. *Id.* (The Securities and Exchange Commission noted that the Supreme Court has "repeatedly . . . emphasized . . . that implied private actions [under Rule 10b-5] provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" (quoting *Bateman Eichler, Hill Richards, Inc. v. Berner,* 472 U.S. 299, 310 (1985)).

Federal securities laws were also adopted for the purpose of efficiency in enforcing in one case all claims that arise out of a single transaction. As commentators have written,

> The securities laws create nationwide service of process and have a liberal venue rule that permits litigation to consolidate all defendants and all claims in a single forum. The class action device created by Rule 23 of the Rules of Civil Procedure makes it easy to bring all plaintiffs together.

Easterbrook and Fischel, *Mandatory Disclosure and the Protection of Investors,* 70 Va.L.Rev. 669, at 680 (1984). The fraud on the market doctrine has special and obvious appeal in class actions because the need to prove a personalized reliance by each class member is avoided. The question of reliance usually arises in the context of whether

or not to certify a class.[7] If a plaintiff in a securities fraud action must plead and prove individual reliance, then class certification is probably improper, because issues of individual reliance will predominate. If the class action procedural device can no longer be used to handle major securities cases, then defendants will gain some measure of relief because not all defrauded investors will sue.–As one commentator pointed out:

> The only person whose behavior is likely to be changed are would-be defrauders, because the fraud-on-the-market theory, by eliminating issues of individual reliance, facilitates class action recovery of claims that would otherwise be too small to be litigated individually. And here, possibly, lies an unstated rationale for the fraud-on-the-market decisions, almost all of which involved class actions: only if courts allow class actions to proceed will under-inclusive recoveries and hence a failure to deter fraud at its inception be avoided.

(footnote omitted) Note, *Fraud-on-the-Market Theory,* 95 Harv.L.Rev. 1143, at 1159 (1982). Moreover, there will no doubt be many separate suits filed by investors who are in a position to plead and prove individual reliance. The cost to the judicial system in litigating each of such suits separately will likely be unacceptable.

Petitioners argue that the fraud on the market doctrine is inconsistent with the full disclosure policy of the se-

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[7]For example, in *In re LTV Securities Litigation,* 88 F.R.D. 134 (N.D.Tex. 1980), the question of whether to apply the fraud on the market doctrine arose in the context of a motion to certify a class of more than 100,000 members who traded nine (9) different types of securities over a period of three and a half years. *Id.* at 140.

curities laws. Such is not correct. In fact, it is obvious that the fraud on the market doctrine could not exist without the full disclosure contemplated by the securities laws. The doctrine assumes that the markets have assimilated all available information. However, liquidity in the markets requires that investors who have not had an opportunity to read every disclosure made by a company, or who may not be sophisticated enough to understand all the disclosures, may nevertheless invest at the market price upon the assumption that such price represents the consensus price established by interested and informed investors. "Various market professionals still have an incentive to secure information until a marginal dollar invested in processing information equals the profits to be made from trading on superior forecasting."[8]

Petitioners' argument that the fraud on the market doctrine establishes a policy of "investor's insurance" implies that each investor can collect his full damages in the event he loses money as a result of securities fraud. This contention is totally unfounded. Even if individual reliance is presumed until defendants have an opportunity to rebut the presumption, it remains necessary for defrauded investors to prove fraud. What Petitioners seek

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[8]Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus.L. 1, at 4 (1982). Professor Fischel explains it, "Markets may be analyzed as having two classes of participants. One class will have a comparative advantage, actors in this class have an incentive to invest in gathering and analyzing information and to take actions to affect the market. The other class, however, lacking a comparative advantage, has no incentive to invest in processing information because it cannot profit thereby. The first group will earn a superior return commensurate with their greater investment skill." *Id.*

is practical immunity from prosecution for corporate wrongdoers. Even if a defrauded investor can prove liability, the plaintiff still recovers only his out-of-pocket damages. The out-of-pocket damage rule established in *Green v. Occidental,* 541 F.2d 1335, 1341 (9th Cir. 1976) (Sneed, J., concurring); *see, e.g., In re LTV Securities Litigation,* 88 F.R.D. 134 (N.D.Tex. 1980), permits an investor to recover only that portion of his total loss which is due to defendants' fraud. While most class actions are indeed settled, the settlements frequently result in a recovery of only pennies on the dollar to defrauded investors. This is scarcely a plan for "investor insurance," but is an effective plan for keeping corporate management as honest as possible.

Petitioners' argument that upholding fraud on the market claims under Rule 10b-5 constitutes the effective repeal of Section 18(a) is similarly unfounded. Petitioners ignore the fact that in this case Plaintiff alleges a scheme to defraud the market by disseminating fraudulent information not only in the SEC filings, but also in publicly disseminated reports appearing in *The Wall Street Journal.* Section 18(a) limits its remedy to fraudulent SEC filings. Furthermore, this Court has already rejected an interpretation of the securities laws that displaces an action under Section 10(b) merely because of the availability of express remedies under other sections. In *Herman & MacLean v. Huddleston,* 459 U.S. 375, 384-387 (1983) this court said, "In savings clauses included in the 1933 and 1934 Acts, Congress rejected the notion that the express remedies of the securities laws would preempt all other rights of action . . . We therefore reject an interpretation of the securities laws that displaces an

action under Section 10(b)." (footnotes omitted). A cumulative construction of the securities laws furthers the broad remedial purposes of the securities laws and furthers Congress' intent in enacting the 1934 Act, "to impose requirements necessary to make [securities] regulation and control reasonably complete and effective." *Id.* (quoting 15 USC Section 78b [15 USCS Section 78b]).

Courts have similarly rejected the notion that there must be additional and differing elements contained in a Section 10(b) claim to justify a civil remedy under 10(b) when other remedies were available under other sections of the Securities Acts. *See, e.g., Chemetron Corp. v. Business Funds, Inc.,* 718 F.2d 725 (5th Cir. 1983). Nonetheless, plaintiffs face a more difficult task in stating a claim under section 10(b) where plaintiff must allege *scienter,* as opposed to stating a claim under Section 18 where an allegation of *scienter* is not a requirement. *Ross v. A.H.Robins Co.,* 607 F.2d 545, 556 (2d Cir. 1979), *cert. denied,* 446 U.S. 949 (1980).

III. THIS COURT HAS PREVIOUSLY CONSIDERED THE INDIVIDUAL RELIANCE ISSUE IN THE SECURITIES FRAUD CONTEXT

Two decisions by this Court, *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375 (1970) and *Affiliated Ute Citizens v. United States,* 406 U.S. 128 (1972), demonstrate this Court's recognition that under certain circumstances, causation in a securities fraud suit is adequately established by proof of materiality, without direct proof of individual reliance.

In *Mills* this court expressly noted the judicial utility in substituting materiality for direct proof of reliance in

large securities fraud cases. In *Mills,* minority shareholders alleged, under Section 14(a) of the Exchange Act, 15 U.S.C. Section 78n(a) (1976), that shareholder approval of a merger had been obtained via a misleading proxy statement. This Court acknowledged that "reliance by thousands of individuals . . . can scarcely be inquired into." *Id.* at 380 (citation omitted). As an alternative, this Court stated,

> There is no need to supplement this [materiality] requirement . . . with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury . . .

Id. at 384-85. The *Mills* case is also informative because this Court found liability without proof of individual reliance, even though *Mills* involved an implied remedy under Section 14(a). Like Section 10(b) of the Exchange Act, the remedy under Section 14(a) is a judicially implied remedy.

In *Affiliated Ute,* a Rule 10b-5 case, this Court dispensed with the need of plaintiffs to establish reliance in nondisclosure cases involving open market transactions. Like the Court of Appeals in this case, this Court noted the distinction between paragraph (2) of rule 10b-5 and paragraphs (1) and (3), saying that the former is restricted to "the making of an untrue statement of a material fact and the omission to state a material fact." *Id.* at 152-153. Nevertheless, this Court continued, the first and third paragraphs are not so restricted, they deal with a course of business or a device, scheme, or artifice that operated as a fraud. *Id.* Thus, this Court held,

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision . . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

Id. 153-154. *Affiliated Ute* has been widely interpreted as eliminating plaintiff's need to establish reliance in nondisclosure cases involving open market transactions. *E.g.*, *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 717 (8th Cir. 1978); *Rifkin v. Crow*, 574 F.2d 262-63; *Dorfman v. First Boston Corp.*, 62 F.R.D. 466, 471 (E.D.Pa. 1974).

The decision by the Court of Appeals below hardly conflicts with decisions by this Court. To the contrary, the decision below embraces policies long recognized by this Court that in certain securities fraud suits, materiality oftentimes sufficiently establishes causation in fact. Where through a scheme to defraud or course of business a defendant disseminates misrepresentations that artificially inflate the market price for a security, plaintiffs should be entitled to a presumption of reliance upon proving materiality.

IV. PETITIONERS DO NOT HAVE STANDING TO ASSERT THE CONFLICT WITHIN THE CIRCUITS AS A REASON FOR THIS COURT TO GRANT CERTIORARI.

Article III of the constitution limits the judicial power of the United States to resolution of "cases" and "controversies." As an incident to this requirement, this Court

has always required that a litigant have "standing." To have "standing" a litigant must show that he personally has some actual or threatened injury. *Valley Forge College v. Americans United,* 454 U.S. 464, 471-473, 70 L.Ed. 2d 700, 102 S.Ct. 752 (1982).

On page fifteen of their brief, Petitioners urge this Court to grant certiorari because of an alleged conflict within the Circuits. Petitioners contend that the Fifth Circuit's decision in this case is in conflict with decisions in other Circuits. In this case the Fifth Circuit held that a plaintiff is permitted to assert a fraud on the market theory under 10b-5(1) and (3), but not under 10b-5(2). In 10b-5(2) cases, plaintiffs must still prove individual reliance upon specific misrepresentations. In their opinion, the Fifth Circuit recognized that other Circuits permit the fraud on the market theory under 10b-5(2).[9] Nevertheless, the Court declined to so hold and for this reason upheld the District Court's dismissal of Respondent's claim stated under 10b-5(2). The Fifth Circuit's decision thus favored Petitioners. Due to the conflict, Petitioners need only defend themselves against claims stated under 10b-5(1) and (3). Consequently, Petitioners cannot urge the conflict among Circuits as a basis for this Court to grant certiorari. Petitioners have suffered no injury. They have actually benefited from the conflict among Circuits.

It is Respondent who has suffered injury by virtue of the conflict among Circuit Courts. If Respondent could

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[9]*See, e.g., Peil v. Speiser,* 806 F.2d 1162-63; *Lipton v. Documation,* 734 F.2d 740; *Blackie v. Barrack,* 524 F.2d 891.

have brought this action in the Third or Eleventh Circuits, her claim under 10b-5(2) would not have been dismissed. Such is not the case, however, and Respondent has suffered an injury in the dismissal of part of her case. Notwithstanding the conflict among Circuit Courts, the injury is peculiar to Respondent, and Respondent alone may urge the conflict among the Circuits.

V. THIS CASE DIFFERS FROM BASIC V. LEVINSON WHICH IS CURRENTLY BEFORE THIS COURT.

On page 19 of their brief Petitioners argue that this Court should consider this case as a companion to *Levinson v. Basic,* 786 F.2d 741 (6th Cir. 1986), *cert. granted,* 107 S.Ct. 1284 (Feb. 23, 1987) (No. 86-279). These cases differ, however, and should not be considered as companion cases. First, as admitted by Petitioners, *Basic, Inc.* raises the issue in the context of class certification under Fed.R.Civ.P. 23(b)(3). The standard of review is abuse of discretion. In this case, the issues arise under a Fed.R.Civ.P. 12(b)(6) motion to dismiss, presenting a pure question of law. Thus, these cases are to be reviewed under differing standards.

Second, *Basic, Inc.* does not distinguish between causes of action stated under 10b-5(1) and (3), and causes of action stated under 10b-5(2). *Basic, Inc.* considers material misrepresentations in public statements relating to the existence of merger negotiations. There is no issue as to a scheme to defraud or course of business that operated as a fraud. *Basic, Inc.* is primarily a 10b-5(2) case. This case on the other hand hinges on a scheme to defraud or

course of business to defraud in violation of Rule 10b-5(1) and (3).

Further, *Basic, Inc.* presents questions of whether *sellers* may utilize the fraud on the market doctrine as well as *purchasers*. This issue is not presented on this appeal.

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CONCLUSION

For the foregoing reasons, the Petition For A Writ Of Certiorari to review the decision of the United States Court of Appeals for the Fifth Circuit should be denied.

Respectfully submitted,

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September 1987.